competitive performance in the market."[31] As shown by Dr. Lehr, to continue transparency and notice periods for the major portion of AT&T's settlement costs on these routes, while exempting most other U.S. carriers from similar requirements, would similarly "slow[] rivalry" in the international market.[32] All U.S. carriers should rather be subject to the same disclosure or non-disclosure requirements.

2. Different Treatment of U.S. Carrier Arrangements Would Encourage Whipsawing.

Dominant foreign carriers seeking to preserve and increase their settlement rate profits would also benefit from this different treatment of U.S. carriers. As demonstrated above, whipsawing remains a significant enduring concern, not only in connection with "foreign carriers with monopoly power," as stated by the Notice (¶ 18), but also by foreign dominant carriers facing some competition, unless the dominant carrier has already lowered settlement rates to "best practice" levels, or unless U.S. carriers can avoid the settlements process altogether by terminating their traffic through viable ISR arrangements in the foreign market.

Additionally, foreign dominant carriers in countries that have not lowered their settlement rates to the benchmarks required by the *International Settlement Rate Order* now have further incentives to leverage U.S. carriers through whipsaw behavior. Because U.S. carrier complaints are required to initiate the benchmark enforcement procedures established by the *International Settlement Rate Order*, foreign dominant

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[31] *Motion of AT&T Corp. to be Declared Non-Dominant for International Service*, 11 FCC Rcd. 17963, 17966 ("*AT&T International Non-Dominance Order*") (1996).

carriers in non-compliant countries may seek to prevent such complaints by punishing, dissuading, or rewarding U.S. carriers accordingly.

The proposal set forth in the Notice would encourage such misbehavior by giving added flexibility to arrangements with dominant carriers in all multi-carrier WTO markets. Unlike the proposal elsewhere in the Notice for the removal of the ISP with dominant carriers, there would be no threshold requirement even for benchmark settlement rates. Indeed, a number of the multi-carrier WTO markets with which such arrangements would be allowed -- such as the Dominican Republic, El Salvador, Indonesia, Jamaica, Malaysia, Mexico and the Philippines -- do not allow ISR, have settlement rates many times higher than cost, and will not be subject to benchmark rates until 2000 or 2001.[33]

The dominant carriers in these markets would inevitably seek to exploit the competitive U.S. market to maintain or raise the cost of terminating U.S.-outbound traffic, lower the amounts they pay U.S. carriers for terminating U.S.-inbound traffic, and thereby raise U.S. outpayments. For example, they could increase their settlement profits (and U.S. outpayments) simply by terminating U.S.-inbound traffic in separate below-25

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32 *Id.*

33 Flexible arrangements with dominant carriers in effectively competitive multi-carrier markets with settlement rates at the best practices level, such as Sweden and the UK, do not give rise to potential concern. The ability of U.S. carriers to terminate calls in those countries with other carriers at rates approximating cost, either under traditional correspondency arrangements or through ISR, ensures that flexibility will not raise U.S. settlement rates or outpayments.

percent arrangements with the lowest bidding U.S. carriers. If the dominant foreign carriers in these markets could enter into secret arrangements with some U.S. carriers, while AT&T remained subject to filing requirements for the majority of its traffic on those routes, the bargaining position of the dominant foreign carriers would be further strengthened, as demonstrated by Dr. Lehr. As a result, the benefits of flexible arrangements are more likely to accrue to the dominant foreign carriers than to U.S. consumers.

To demonstrate the potential harm to the U.S. public interest from this proposal, the Commission need look no further than Mexico, a multi-carrier WTO market, where the latest $0.395 settlement rate was more than five times higher than cost, and U.S. carriers' $875 million outpayments in 1996 were almost three times larger than on any other route. Although the Mexican market was nominally opened to competition in 1997, the Mexican government has sought to protect the settlement profits of the dominant incumbent carrier, Telmex, by, among other things, prohibiting its competitors from negotiating settlement rates with U.S. carriers[34] and by failing to honor Mexico's WTO obligation to allow ISR services. Because of the regulatory barriers protecting Telmex, Mexico's status as a multi-carrier WTO market would provide little or no protection against whipsaw behavior by Telmex. Other WTO Member countries, in Latin

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[34] *See* Rules to Render the International Long-Distance Service That Must be Applied by the Concession Holders of Public Telecommunications Networks Authorized to Render this Service ("International Long-Distance Service Rules"), Ministry of Communications and Transport, Mexico, Dec. 4, 1996), Rule 13.

America and elsewhere, have implemented or are considering similar regulations to protect their incumbent carriers from competition.

The Commission's *Flexibility Order* recognized that the potential adverse effects on the public interest of below-25 percent alternative settlement arrangements required potential Commission review of all such arrangements "regardless of whether they trigger our safeguards, to ensure that they meet our policy objectives and will not have a significant adverse impact on U.S. net settlement payments and resulting traffic volumes."[35] Although the Commission expressly retained this right of review in the *Foreign Participation Order*,[36] no such review can occur if carriers are under no obligation to file a summary of the terms and conditions of below-25 percent arrangement and to identify the foreign correspondent, as proposed by the Notice. The Notice fails to recognize this inconsistency with the safeguards established by the *Foreign Participation Order* and identifies no subsequent change in circumstances warranting the removal of this Commission review after such a brief interval.

The Commission should also review whether the continuation of its flexibility policies is necessary at all if the ISP is removed for all foreign non-dominant carriers and in all markets that are sufficiently competitive. Notably, the adoption of this approach would achieve the flexibility originally sought by the 1996 *Flexibility Order*. That order allowed flexibility with foreign carriers in markets satisfying the ECO test and in other markets where "deviation from the ISP will promote market-oriented pricing and

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35 *Flexibility Order*, 11 FCC Rcd. at 20087 (1996).

competition, while precluding abuse of market power."[37] It specifically cited arrangements with foreign non-dominant carriers and in markets "where a foreign regulator guarantees cost-based interconnection for international traffic" as providing examples of these latter circumstances.[38]

The removal of the ISP for arrangements with non-dominant carriers in all markets, and for all carriers in markets satisfying the threshold tests proposed by AT&T in Section I above (*i.e.*, where settlement rates are at best practice levels or U.S. carriers can engage in ISR on a viable basis), would allow complete flexibility in all the market circumstances specified by the *Flexibility Order*. For the reasons described above, allowing greater flexibility, particularly if there is no disclosure for under-25 percent arrangements, merely encourages the "abuse of market power by a foreign carrier to the detriment of U.S. carriers" anticipated by the *Flexibility Order*.

3. The 25 Percent Threshold For Alternative Settlement Arrangements Should Be Removed.

AT&T welcomes the request (¶ 37) for comment on the flexibility safeguards, and (¶ 50) for further comment on the issues raised by the petitions for reconsideration of the *Flexibility Order*, and again requests the removal of the unjustified and discriminatory criteria and filing requirements imposed on 25 percent or above

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36 *Foreign Participation Order*, ¶ 308 ("We retain this right here.")

37 *Flexibility Order*, 11 FCC Rcd. at 20080.

38 *Id.*

alternative settlement arrangements. AT&T demonstrated in its March 1997 Petition for Reconsideration of the *Flexibility Order* and April 1997 Reply Comments that the 25 percent threshold is entirely arbitrary, with not one scintilla of evidentiary support in the record, and contrary to the finding elsewhere in the *Flexibility Order* that alternative settlement arrangements should not be limited to certain carriers on the basis of "size-based criteria."[39]

Efforts by the respondents to AT&T's original petition to justify the 25 percent threshold were little more than arguments that a 25 percent market share equates to market power on a route. Their arguments were in direct contradiction of the Commission's prior findings in the 1996 *AT&T International Non-Dominance Order* that AT&T lacks market power and that "market shares, by themselves, are not the sole determining factor of whether a firm possesses market power."[40] Indeed, the permanent competitive disadvantage imposed on AT&T by the 25 percent threshold is at variance with the Commission's recognition in the 1996 *AT&T International Non-Dominance Order* that dominant regulation "may <u>hinder</u> competition . . . if applied to a carrier that no longer has market power."

Because smaller U.S. carriers may use flexible arrangements to lower settlement rates for all of their traffic on a route, an opportunity denied to AT&T, the

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[39] *Id.* at 20076, 20080. *See also,* Lehr Aff. at 3 ("the 25% rules asymmetrically singles out carriers such as AT&T that happen to have the largest share of traffic along a particular route"); *id.* at 6 (25% is an "arbitrary" choice).

25 percent threshold allows smaller U.S. carriers to obtain a lower overall per minute settlement rate than AT&T, and thus to price at lower levels. As shown above, the new proposal set forth in the Notice to draw a veil of secrecy over below-25 percent arrangements would further tilt the competitive playing field against AT&T.[41]

There is also no justification for the proposals made in the petitions by PBCom and NYNEX to further increase the disadvantages imposed on AT&T's flexible arrangements. These proposals would establish a presumption that exclusive arrangements are unreasonably discriminatory, requiring that all 25 percent and above flexible arrangements be offered on an identical basis to all U.S. carriers, and imposing a continuing obligation to justify such arrangements. Their proposal would impose obligations far beyond the requirements of the ISP, which has never required absolute uniformity or made U.S. carriers responsible for the availability of operating agreements to all other U.S. carriers.[42] Moreover, the fact that an exclusive arrangement may not be

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40 *AT&T International Non-Dominance Order*, 11 FCC Rcd. at 17976. *See also, Foreign Participation Order*, ¶ 161 ("We recognize that market share is but one factor in a traditional market power analysis.").

41 As stated in its original petition, AT&T does not seek the removal of the 25 percent threshold on inbound traffic for as long as settlement rates are above cost-based levels in order to limit the potential diversion of inbound traffic through these arrangements.

42 *See Implementation and scope of the International Settlements Policy for Parallel International Communications Routes*, 2 FCC Rcd. 1118 (1987) ("[U]niformity is not an end in itself. Our objectives are to ensure that American consumers receive the benefits that result from the provision on international services on a competitive basis. Departures from uniformity are permissible if the particular departure does not conflict with these objectives.")

available to all carriers does not mean that it is unreasonably discriminatory. For example, an exclusive arrangement affecting more than 25 percent of the traffic on a route would not be unreasonably discriminatory if it was entered into with one of many competing carriers in a market subject to effective competition.

There is also no justification for retaining the filing requirements for alternative settlement rate arrangements with affiliated carriers and joint venture partners that lack market power. As the Notice concludes (¶ 34), there is no likelihood that such an arrangement would have anticompetitive effects. The Commission already allows special concessions with such carriers and does not impose dominant carrier regulation on such routes. The Notice proposes to remove the ISP for traffic terminated with non-dominant carriers, thus allowing flexible arrangements with all non-dominant non-affiliated carriers, and there is no reason for any different treatment of non-dominant affiliates and joint venture partners.

III. THE COMMISSION SHOULD MAINTAIN ITS EXISTING ISR RULES.

As the Notice emphasizes (¶ 37), the prevention of one-way bypass has been a long-standing Commission concern. ISR authorizations leading to the inbound bypass of settlements "could increase the net settlements payments of U.S. carriers, and ultimately could lead to increased calling prices for U.S. consumers," which would be the exact opposite of the intended result of authorizing ISR services "as a mechanism for putting greater pressure on settlement rates." (*See, id.*) The modifications to the ISR rules suggested by the Notice, however, fail to meet the acknowledged requirement (¶ 38) of being "consistent with [the Commission's] commitment to prevent one-way bypass."

They would do little to lower settlement rates, while extending these services to routes raising serious risks that bypass would occur.

The Commission only recently modified its ISR rules in the *Foreign Participation Order* to allow these services where 50 percent of traffic is settled at benchmark rates. Although it also established quarterly reporting requirements and a market distortion presumption to address bypass concerns, it is not yet possible to evaluate the adequacy of these new safeguards. They will also be rendered largely ineffective by the removal of the traffic distinctions on which they depend with the removal of the ISP.

1. The Suggested Modifications Would Raise Bypass Risks While Failing to Encourage Lower Settlement Rates.

The Notice suggests (¶ 38) that ISR should be authorized for "a limited amount of traffic" on routes not otherwise qualifying for ISR, and that the Commission should "lift [its] ISP requirement at some future point when international markets have become sufficiently competitive overall, *e.g.*, when 50 percent of routes have been approved for ISR." The adoption of either change to the Commission's recently modified ISR rules would simply encourage one-way bypass by the very countries that have the greatest incentives to engage in this conduct.

The Commission now approves WTO routes for ISR either when 50 percent of the traffic on the route is terminated at benchmark rates or when equivalency requirements are fulfilled. By definition, WTO countries meeting neither of these requirements are those with high settlement rates and that prohibit U.S. carriers from engaging in ISR on a viable basis. Most are dominated by existing or former monopolists with greater incentives to engage in one-way bypass than carriers complying with benchmark rates because of the greater profits that may be obtained by bypassing higher settlement rates.[43]

Opening ISR to all countries at some future point or introducing an "ISR quota" on all routes would do little or nothing to lower settlement rates, as most of the new countries to which ISR would be authorized do not allow U.S.-outbound calls to be terminated in this way. However, it would undoubtedly encourage one-way in-bound bypass by the foreign carriers with the greatest incentives to engage in this activity. Further, the adoption of the proposals to reduce the scope of the ISP and allow secret under 25 percent flexibility arrangements set forth elsewhere in the Notice would limit the relevance of the ISR rules even further. Foreign monopoly carriers with above-benchmark rates would then be the only possible beneficiaries of these policies.[44]

Additionally, a quantitative restriction on the amount of ISR traffic on any route would merely address the size of the potential inbound bypass harm to U.S. consumers and carriers. It would do nothing to reduce the likelihood or change the nature

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43 *See International Settlement Rate Order*, 12 FCC Rcd. at 19918 (finding that "the requirement that settlement rates be at or below the relevant benchmark substantially reduces the financial incentives to engage in one-way bypass").

44 This would be the effect if the Commission adopted the proposals to (a) remove the ISP from all arrangements with foreign non-dominant carriers, (b) remove the ISP from arrangements with all carriers in WTO markets meeting the settlement rate benchmarks, and (c) allow secret under-25 percent flexibility arrangements in multi-carrier WTO markets. Moreover, if this proposal was adopted, any removal of the ISP on all routes on which ISR was allowed by the Commission would automatically remove the ISP for all WTO countries, and further increase the widespread anticompetitive abuse that would inevitably result from this approach.

of that harm. It is also unclear how any "ISR quota" on each route would be distributed among carriers on an equitable basis and consistent with the antitrust laws without extensive regulation by the Commission.

2. No Reliance Should Be Placed On New And Untested Reporting Safeguards.

It is also highly premature to reach any conclusion regarding the effectiveness of the Commission's reporting safeguards for ISR and whether they would prevent one-way bypass "in lieu of" other existing safeguards, as the Notice requests (¶ 38). Those safeguards employ a presumption that market distortion exists if the ratio of inbound/outbound traffic increases by ten percent or more over two successive reporting periods. They were adopted when the Commission modified its ISR rules in the *International Settlement Rate Order* to allow these services on routes where 50 percent of the traffic is settled at benchmark levels.[45]

The Commission did not subsequently issue its first ISR authorization under these new procedures until April 30, 1998.[46] Additionally, the quarterly reporting obligations did not become effective until this year and only two quarterly reports have thus far been filed, on April 30, 1998 and July 31, 1998. Individual carrier filings are

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[45] The Commission found that "[w]ith these reporting requirements" it was "not necessary to adopt AT&T's proposed alternative that we grant [ISR] authorizations . . . on the condition that accounting rates on the route in question are at or below the low end of the benchmarks." *Id.* at 19920.

[46] *AT&T Corp., et al.*, Order and Authorization, File Nos. ITC-98-137, ITC-98-138, ITC-98-139, ITC-98-140, ITC-98-141, ITC-98-195, (rel. Apr. 30, 1998) (authorizing ISR services to Luxembourg, Norway, Denmark, France, Germany and Belgium).

confidential and no consolidated report has been published for either quarter. It is thus much too early to assess the effectiveness of these reporting requirements.

Further, any present effectiveness of this safeguard would be largely removed by the adoption of the proposals in the Notice to remove the ISP from all non-dominant carriers and from all carriers on some routes. The removal of the ISP would remove all distinctions between traffic settled under "ISP" and flexibility arrangements and would also largely remove the distinction between "settled" and ISR traffic.

While the blurring of these categories would render the present reporting safeguard highly unreliable, it would not remove the potential bypass harm that it seeks to prevent. Foreign carriers would still seek to increase U.S. outpayments by terminating U.S.-inbound traffic cheaply in the U.S., while maintaining high rates on U.S.-outbound traffic.

3. <u>Other Countries' ISR Policies Do Not Provide A Model For The U.S.</u>

Finally, the fact that other countries may not regulate the provision of ISR in the same manner as the U.S. (Notice, ¶ 38) does not suggest that a change in U.S. policies is required. Other countries' policies inevitably reflect their different circumstances and priorities and are not necessarily applicable to the U.S. In particular, while information concerning settlements in the UK, Sweden and Germany (the countries specifically referenced by the Notice) is limited, and only the UK (and New Zealand) publishes its settlement rates like the U.S., none of these countries appears to have a huge settlements deficit like the U.S.

With their inbound and outbound settled traffic more closely in balance, settlements outpayments are a less serious problem for these countries and the need to prevent bypass activities that may further increase those payments does not give rise to the same concerns as in the U.S. As a further indication of the different sensitivities concerning settlements payments in these countries, none of them, for example, has taken similar actions to the U.S. to require the payment of lower settlement rates to foreign carriers.

IV. THE BOCS SHOULD BE PRECLUDED FROM ACCEPTANCE OF GEOGRAPHICALLY GROOMED TRAFFIC.

Any removal of the ISP, even for arrangements with foreign non-dominant carriers, or approval of secret under 25 percent flexibility arrangements should not extend to those involving the acceptance of geographically "groomed" inbound international traffic by the Bell Operating Companies ("BOCs"). (Notice, ¶ 43.) These carriers should rather be precluded from acceptance of this type of inbound traffic before their access charges are reduced to cost-based levels.

. As described in the attached affidavit by Dr. Lehr (pp. 3, 9-10) the BOCs' bottleneck control over local access facilities in the U.S. and above-cost access charges provide potential advantages in the in-region termination of inbound international calls that would allow them to use their market power to subsidize entry into the international market or to engage in strategies to raise other U.S. carriers' costs. Because a BOC incurs a lower cost of access for calls terminating in its region than other U.S. carriers, it can offer foreign carriers a lower inbound rate than other carriers and thus encourage foreign carriers to geographically "groom" their U.S.-bound traffic for cheaper termination by the BOC. This would divert U.S. in-bound traffic from other carriers, thus raising their net settlements payments to foreign carriers. As Dr. Lehr concludes (p. 10), this strategy would offer "an especially attractive way to raise their rivals' costs."

Moreover, there would be a strong community of interest between the BOCs and dominant foreign carriers. Both "have a mutual interest in preserving and/or leveraging their dominant market positions with respect to bottleneck facilities into adjacent markets." Lehr Aff. at 9. Dominant foreign carriers would obtain substantial advantages from the lower termination prices offered by the BOCs as they would be able to avoid their high settlement rates on U.S.-inbound calls. Consequently, such arrangements would further harm the U.S. public interest by increasing the foreign carriers' above-cost settlements profits and U.S. settlement outpayments.

CONCLUSION

For the reasons explained above, AT&T supports the proposal to remove the ISP with foreign carriers that lack market power. AT&T supports the removal of the ISP with all carriers, however, only in markets where settlement rates are at "best practice" levels, or where U.S. carriers are able to terminate traffic through viable ISR arrangements. The Commission should not provide secrecy for under-25 percent flexibility arrangements, and should maintain the existing ISR rules and continue to prohibit grooming arrangements with the Bell Operating Companies.

Respectfully submitted,

AT&T CORP.

By Lawrence Lafaro

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Dated: September 16, 1998

ATTACHMENT 1

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
1998 Biennial Regulatory Review --Reform of the International Settlements Policy and Associated Filing Requirements	)	IB Docket No. 98-148
	)	
Regulation of International Accounting Rates	)	CC Docket No. 90-337
	)	

AFFIDAVIT

OF

WILLIAM H. LEHR

ON BEHALF OF

AT&T CORP.

1. Statement of Qualifications

My name is William H. Lehr. My business address is 94 Hubbard Street, Concord, MA 01742.

I am an associate research scholar in Columbia University's Graduate School of Business, a research associate at the Columbia Institute of Tele-Information, and a consultant to the Massachusetts Institute of Technology Internet Telephony Consortium. My research focuses on the economics of telecommunications and related information technology industries. In addition to my academic research in the area, I have significant professional experience in the telecommunications industry through positions at consulting firms, at MCI, and as an independent industry consultant. Prior to joining the Columbia faculty in 1991, I received my Ph.D. in economics from Stanford University. My M.B.A. (Wharton), M.S.E. (chemical engineering), B.S. (chemical engineering, *cum laude*), and B.A. (European history, *magna cum laude*) degrees are from the University of Pennsylvania. My business address is 94 Hubbard Street, Concord, MA 01742. A copy of my *Curriculum Vitae* with additional details is attached as Attachment 1.

2. Introduction

This affidavit provides comments on the FCC's recent Notice of Proposed Rulemaking (NPRM)[47] regarding modifications to the International Settlements Policy (ISP) (hereafter, the *Settlements NPRM*). Specifically, I have been asked to address the two following changes contemplated by the *Settlements NPRM*: (1) removing filing requirements for flexible settlements agreements involving less than 25% of the inbound or outbound traffic on a route;[48] and (2) relaxing the restriction against Local Exchange Carriers (LECs) from entering into flexible settlement agreements to groom traffic geographically.[49] Both changes would be inconsistent with the goal of promoting increased competition in telecommunications markets, and therefore, harmful to the public interest. My affidavit explains why the asymmetric 25%-rule is arbitrary, harmful to competition, and should be eliminated; while the restriction against LEC grooming agreements is appropriate, necessary to safeguard competition, and should be retained.

The biggest challenge facing international telephone competition is the absence of effective competition in both foreign and US markets for the local access facilities that are essential inputs to both originate and terminate international calls. This lack of competition facilitates the maintenance of settlement rates that are significantly

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47 *Notice of Proposed Rulemaking In the Matter of the 1998 Biennial Regulatory Review Reform of the International Settlements Policy and Associated Filing Requirements*, IB Docket No. 98-148, and Regulation of International Accounting Rates, CC Docket No. 90-337, Federal Communications Commission, Washington, DC, Adopted August 6, 1998 (hereafter, "*Settlements NPRM*").

48 See *Settlements NPRM*, note 47, *supra*, paragraphs 33-35.

49 See *Settlements NPRM*, note 47, *supra*, paragraph 43.

above cost, resulting in excessive prices for international telephone service in some markets. Indeed, the FCC's motivation for permitting flexible settlements agreements is, in part, to encourage pressure to reduce these accounting rates closer to the cost of providing service.[50]

The incumbent LEC's in the US and the dominant carriers in foreign markets possess substantial market power over these essential bottleneck origination and termination facilities. In situations where access charges or settlement rates are above cost, both have an ability to protect and leverage their market power over local facilities into international service markets. Regulatory oversight is needed and justified to safeguard competition from these carriers exploiting their market power anticompetitively. Therefore, the restriction against LEC grooming contracts is needed to prevent the LECs from using their market power over local services and the revenues they receive from excessive access charges to subsidize their entry into international competition or to engage in anticompetitive activities aimed at raising rivals' costs.

In contrast, the 25%-rule asymmetrically singles out carriers such as AT&T that happen to have the larger shares of traffic along a particular route. If AT&T possessed market power analogous to the power possessed by the LECs over local access facilities or the foreign carriers over both foreign access and international services, then discriminatory treatment might be warranted (although the choice of 25% as the demarcation point would still be arbitrary). However, this is not the case. The FCC concluded that "AT&T has demonstrated that it lacks market power in international

[50] See *Settlements NPRM*, note 47, *supra*, paragraph 13.

telecommunications markets" and therefore, declared AT&T a non-dominant carrier in 1996.[51]

Applying asymmetric regulatory constraints to a subset of carriers that do not possess market power is anticompetitive. It distorts competition among the remaining participants without market power and strengthens the position of those that actually possess such power. The 25%-rule adversely affects the opportunities and the abilities of carriers such as AT&T to negotiate efficient settlements contracts with foreign carriers. This raises their costs above competitive levels and above those of other participants in the market. The 25%-rule preferentially favors carriers that happen to have a small market share of the outbound traffic on a route, irrespective of their market power in other related markets. Because the incumbent LECs are likely to be below the 25% threshold, they will not face constraints imposed on competitors like AT&T, offering the LECs another opportunity to extend and protect their market dominance over local access markets in the US. By weakening the competitive position of the carrier with the largest share of traffic in the market, the 25% rule strengthens the bargaining position of the dominant foreign carrier.[52]

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[51] See *Order in the Matter of Motion of AT&T Corp. to be declared non-dominant for international service*, Federal Communications Commission, FCC 96-209, May 6, 1996, paragraph 98.

[52] As I explain further below, anything that weakens a strong competitor, strengthens other strong competitors. Foreign carriers that dominate their local markets represent the biggest threat to effective competition. The US carrier with the largest share is likely to have more experience in negotiating with and operating in the foreign carrier's market and hence offer more effective competition than relatively new

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Relaxing regulatory authority for flexible settlement agreements involving less than 25% traffic on a route while retaining restrictions for agreements involving 25% or more does not meaningfully discriminate on the basis of market power, whereas the restriction against a LEC entering into discriminatory grooming contracts does achieve a meaningful distinction. Retaining (and increasing) the distinction in one instance while eliminating it in the other is inconsistent and compounds the error in both cases. In both instances, the effect will be to harm competition leading to reduced pressure to expand customer choice, improve quality, improve efficiency, and reduce prices. This will harm the public interest.

Section 3 and 4 provide further discussion of the 25% rule and the LEC grooming restriction. In Section 5, I offer concluding recommendations.

3. Why the asymmetric 25% rule should be revised

The FCC is contemplating revising its flexibility policy to authorize flexible settlement arrangements with foreign carriers that do not involve more than 25% of the outbound traffic on a route without any disclosure of the identity of the foreign party or the terms of the agreement.

The problem with the FCC's recommendation is that the public disclosure requirements are to be retained for flexibility agreements involving 25% or more of the outbound or inbound traffic. This means, in effect, that only a subset of the participants in the market will be subject to these asymmetric regulatory costs imposed by the public

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entrants that may be willing to negotiate less efficient settlements agreements in order

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disclosure requirements. This asymmetric burden is increased further by the existing requirement that, in addition to public disclosure, an agreement involving 25% or more of the outbound or inbound traffic shall not "contain unreasonably discriminatory terms and conditions."[53] If interpreted to mean that other carriers may take advantage of any rate negotiated by the larger carrier, then this will further reduce incentives for other carriers to negotiate aggressively, as recognized by the FCC.[54] While the interpretation of what might be constituted as "unreasonably discriminatory" is uncertain, these added limitations applied solely to agreements involving 25% or more of the traffic on a route further increases the unit costs of these carriers and further constrains their opportunities and abilities to successfully negotiate efficient settlement arrangements.

The public disclosure and non-discrimination restrictions are motivated by a desire to safeguard the market from anticompetitive behavior. The only proper basis for applying these rules asymmetrically is where the market may be segmented into carriers with market power that pose a threat to competition and those that do not. The choice of 25% is arbitrary. First, market shares, by themselves are inadequate to determine the existence of market power. Second, a share of only 25% is not regarded as indicative of market power. The effect of this threshold is to single out AT&T (and WorldCom, but for smaller proportions of its traffic than for AT&T), because these are the only carriers that

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to purchase market share to penetrate a new foreign market.

53 See *Settlements NPRM*, note 47, *supra*, paragraphs 34.

54 See *Settlements NPRM*, note 47, *supra*, paragraph 9.

have a market share in excess of the threshold on any routes, while favoring smaller competitors who are able to shelter 100% of their traffic on all routes, regardless of the market power they may possess in related markets.

This is not appropriate because AT&T no longer possesses market power over international services. AT&T's average market share is less than 60%, not much higher than its share in US domestic long distance markets which have been deemed to be competitive for a long time. Moreover, AT&T's share has declined significantly in recent years. Moreover, as noted earlier, the FCC determined in 1996 that AT&T is no longer a dominant carrier in international telephone service.

Applying these regulatory provisions disproportionately to AT&T harms competition because it reduces its ability to negotiate efficient settlement agreements. A foreign carrier will find it more advantageous to negotiate with competitors who do not face the same public disclosure and non-discrimination restrictions imposed on AT&T. If a foreign carrier does negotiate with AT&T it will have an increased incentive to negotiate a higher settlement rate on the majority of AT&T's traffic that is subject to disclosure as a signal to other potential negotiating partners. In addition to this direct effect of imposing higher settlement costs on AT&T, the asymmetric 25% rule forces AT&T to contend with more cumbersome contracting rules.[55] Together, these result in higher unit costs for the largest participant in the market, thereby reducing competition and pressure on the

[55] For example, if AT&T elects to enter into a flexible contract for the portion of its traffic that is below the 25% threshold, it will need to negotiate a separate agreement to cover the remaining share of traffic. The costs of negotiating these multiple agreements is uniquely imposed on large carriers.

dominant foreign carrier to reduce the accounting settlement rates. This will reduce AT&T's ability to compete, and is likely to systematically bias settlement rates upwards, especially if there are scale economies associated with competing in foreign markets. Scale economies imply that a firm with a larger market share is likely to have lower costs than smaller competitors. Imposing restrictions that raise the costs for these larger firms means that these scale economies will not be fully reflected in market prices. The asymmetric rules favor potentially less efficient entrants, resulting in higher prices for end-users.

The participants with significant market power are foreign incumbents and LECs. While the latter currently may have small market shares of traffic on international routes, the LECs possess significant market power over the essential local access facilities required to originate or terminate international traffic in the US. The asymmetric rules that harm AT&T and raise its costs favor these LECs and dominant foreign carriers by reducing the competitive threat to LECs and foreign incumbents posed by AT&T both in international markets and in markets for domestic and foreign local access facilities.

These asymmetric provisions applied to larger carriers create the potential for foreign carriers to whipsaw both AT&T and smaller carriers. The foreign carrier will be able to exploit the reduced experience and potentially higher average fixed costs of an entrant to negotiate a more favorable settlement agreement than if AT&T were allowed to compete on an equal basis. The experience of conditions in foreign markets is likely to contribute to the ability of the carrier to negotiate settlement rates that are closer to the foreign carrier's true costs.

In summary, therefore, applying asymmetric regulatory rules that arbitrarily impose higher costs on AT&T is likely to diminish competition in international services and may result in higher prices to consumers and reduced pressure to lower settlement rates toward cost.

4. Why restrictions against LEC grooming contracts should be retained

The FCC does not currently allow LECs to participate in flexible settlements agreements involving groomed traffic based on geographic termination, but the *Settlements NPRM* is contemplating relaxing this restriction. This would be ill-advised. The LECs possess significant market power over essential local access facilities that are required to both originate and terminate calls. As noted earlier, the LECs and dominant foreign carriers have a mutual interest in preserving and/or leveraging their dominant market positions with respect to bottleneck facilities into adjacent markets. The desire to protect their local dominance from competition provides a sufficient incentive to seek to behave anticompetitively in international markets, even *if* their behavior in international markets is not profitable in its own right (*e.g.*, by raising rivals costs). However, such behavior is likely to be profitable for the LECs.

LECs can subsidize their ability to negotiate favorable grooming contracts by taking advantage of access charges that significantly exceed costs. The advantage afforded by these access charge subsidies provides LECs with the ability to compete unfairly against alternative carriers that might otherwise have lower costs than the LEC. Moreover, by distorting the mix of traffic available to other carriers, these grooming